

## TO OUR MEMBERS

**As our nation emerges, however haltingly, from the deepest recession in years, access to credit will be critical in fostering a real and lasting recovery. Throughout this difficult period, financial institutions, including the members of the Federal Home Loan Bank of San Francisco, have been working to strengthen their capital structures and balance sheets, improve profitability, enhance risk management, and, in some instances, revamp their operating strategies so that they can continue to provide the essential credit needed by the people, businesses, organizations, and communities they serve.**

The Federal Home Loan Bank of San Francisco, too, has taken action to build its strength to better meet the needs of its members, and through them, to accomplish its public policy mission of providing essential funds for housing finance and community economic development. Despite a challenging operating environment, in 2010 we increased retained earnings while paying dividends each quarter, resumed the repurchase of excess capital stock, and continued to evaluate and enhance our risk management policies and practices.

Most important, we continued to fulfill our mission by adapting to the changing needs of our members, providing additional advances to some members while adjusting to decreasing advance demand from others. For a variety of reasons, overall demand for advances continued to decline in 2010, particularly from our largest borrowers. As a result, total advances decreased to \$95.6 billion at the end of 2010 from \$133.6 billion at the end of 2009. In general, member financial institutions maintained high levels of liquidity throughout the year, thanks in part to the strong growth in core deposits that occurred in the wake of the financial crisis. In addition, lending

activity remained subdued because of relatively weak loan demand and because many members continued to build capital and maintain stringent credit underwriting standards in response to weakness in the economy and the housing markets.

The decline in average advance balances was one of several factors that contributed to a decrease in net income in 2010 relative to the prior year. The Bank's net income for 2010 was \$399 million, compared to \$515 million for 2009. Other factors included lower balances of mortgage-backed securities, lower earnings on invested capital as a result of the lower interest rate environment, and a lower net interest spread on advances. These effects were partially offset by a lower other-than-temporary impairment (OTTI) charge related to credit on some of the private-label residential mortgage-backed securities (PLRMBS) in our held-to-maturity securities portfolio. The credit-related OTTI charge was \$331 million for 2010, compared to \$608 million for 2009.

The credit-related OTTI charge for 2010 reflected the impact of additional projected losses on loan collateral underlying some of our PLRMBS. Each

quarter, we update our OTTI analysis to reflect current and anticipated housing market conditions, observed and anticipated borrower behavior, and updated information on the loans supporting our PLRMBS. This process includes updating key aspects of the Bank's loss projection models. The increases in projected collateral losses in our OTTI analyses in 2010 reflected the adverse impact on projected borrower default rates and projected loan loss severity of several factors, including the impact of large inventories of unsold homes on current and forecasted housing prices, of continued weakness in the economy and employment on projected borrower default rates, and of foreclosure procedure errors by loan servicers and their efforts to remediate those errors, which increases foreclosure costs and delays the liquidation of defaulted loans, resulting in higher loan losses.

## Building Our Capital Strength

The Bank's response to the risk of higher-than-anticipated credit-related OTTI losses on our PLRMBS has been to continue building our capital strength. We paid nominal dividends each quarter in 2010 and allocated all other earnings to restricted retained earnings, primarily for the buildup of retained earnings to protect members' paid-in capital from various risks, including the risk of additional OTTI charges. As a result, our annual dividend rate for 2010 was 0.34%, compared to 0.21% for 2009, and the amount of restricted retained earnings designated for the buildup increased from \$1.1 billion at the end of 2009 to \$1.5 billion at the end of 2010. Our current target for the buildup of retained earnings is \$1.8 billion.

As of December 31, 2010, the Bank was in compliance with all of its regulatory capital requirements. The Bank's total regulatory capital ratio was 8.95%, well in excess of the 4.00% requirement. The Bank had \$13.6 billion in regulatory capital, more than triple its risk-based capital requirement of \$4.2 billion.

In light of the Bank's strong regulatory capital position, the Bank began repurchasing excess capital stock in May 2010, and has continued to conduct partial repurchases of excess capital stock each quarter since then. In total, the Bank repurchased \$1.4 billion in excess capital stock in 2010.

The Bank will continue to monitor the condition of its PLRMBS portfolio, its overall financial performance and retained earnings, developments in the mortgage and credit markets, and other relevant information as the basis for determining the status of dividends and capital stock repurchases in future quarters.

In February 2011, the Bank took another step to build its capital strength. Effective February 28, 2011, the 12 Federal Home Loan Banks entered into a Joint Capital Enhancement Agreement intended to strengthen the capital position of each FHLBank. By allocating the portion of earnings historically paid to REFCORP to a separate retained earnings account at each FHLBank once the REFCORP obligation is fully satisfied, the Agreement is intended to create an additional buffer on each FHLBank's balance sheet to help absorb potential losses, to provide additional protection for each member's capital stock investment in its FHLBank, and to enhance each FHLBank's capacity to continue to meet its consolidated obligations, for which all FHLBanks are jointly and severally liable.

## Managing Risk

In addition to its capital strength, the Bank's safety and soundness depend on several other variables, including its effective management of the credit and collateral risks associated with the advances business. In 2010, the Bank continued to monitor and modify the financing availabilities and borrowing capacities of its borrowers on an individual basis, while taking into account both decreases and increases in the current market valuations of pledged collateral. As always, we seek to meet the funding needs of individual members while protecting the capital investment of all our members and ensuring that all advances are fully collateralized.

## Creating Opportunity

One of the most tangible benefits of the Bank's profitable operation is the ability to provide funding for the creation and preservation of affordable housing in the regions served by our members. In 2010, the Bank awarded \$69 million to 120 rental and owner-occupied projects in two competitive rounds of the Affordable Housing Program. These AHP grants will address the diverse affordable housing needs of communities in Arizona, California, Nevada, and seven other states served by our members by facilitating the construction or rehabilitation of 6,588 affordable homes for low- and moderate-income households. Since 1990, the Bank has provided \$630 million to fund 96,684 homes through the competitive AHP.

During the year, the Bank allocated an additional \$15 million in AHP funds through the Bank's first-time homebuyer programs, the Workforce Initiative

Subsidy for Homeownership (WISH) Program and the Individual Development and Empowerment Account (IDEA) Program, to 30 members, including 9 first-time participants. Both WISH and IDEA are matching grant programs that offer up to \$15,000 to eligible households toward the purchase of a home, matching \$3 for every \$1 contributed by the first-time homebuyer. Funds are made available through the Bank's members to households earning up to 80% of area median income and can be used for downpayment and closing costs, both of which can be significant barriers to homeownership. Since 2000, the Bank has funded \$32 million through these programs to help 2,529 low- and moderate-income individuals and families become homeowners.

The Bank awarded \$1 million in grants during the year to help jumpstart 40 innovative affordable housing and community development projects and programs. The Access to Housing and Economic Assistance for Development (AHEAD) Program, which is funded at the discretion of the Bank's Board of Directors, has provided over \$3 million to 134 projects and programs in Arizona, California, and Nevada since 2004.

In 2010, members once again took advantage of the Bank's discounted loan programs to meet the credit needs of low- and moderate-income households and communities. Members borrowed \$243 million in Community Investment Program advances to support affordable housing, \$34 million in Advances for Community Enterprise to support job creation and retention or foster other activities that benefit low- and moderate-income households and communities, and \$61 million in Homeownership Preservation

Advances to support members in modifying or refinancing loans to homeowners at risk of losing their homes because of delinquency or default.

Members also used the Bank's discounted letters of credit extensively in 2010, taking advantage of the temporary amendment to the Internal Revenue Code that allowed standby letters of credit to back non-housing-related tax exempt bonds. The Bank issued 29 standby letters of credit during the year, including \$201 million that supported job creation or retention and \$4.5 million that promoted housing.

## Building for the Future

The severity of the downturn in our nation's housing markets and economy over the last few years has caused great distress for many. While the crisis has already reshaped the housing finance system in a variety of ways, more change is in store, as policymakers continue to explore the causes of the market failures and identify a range of possible solutions to prevent future crises.

As these proposals are analyzed and debated, it is important to recognize the ways in which the structure and business model of the Federal Home Loan Bank System already address certain key policy objectives. As government-sponsored enterprises, the FHLBanks are chartered by Congress to fulfill a public policy mission. To accomplish this mission, they rely on the private capital supplied by their member financial institutions to support the lending activities of those same privately owned financial institutions. The loan collateral pledged by FHLBank System members to secure advances remains on the balance sheets of these institutions, which clearly have a stake

in the long-term viability and profitability of these loans. Through their portfolio lending activities, these members make a long-term investment in their customers and communities in support of homeownership, rental housing, small business, and other forms of economic development.

The strength of the FHLBank System model is based on several unique attributes:

- A cooperative ownership structure that allows the FHLBanks to balance the needs of individual members as borrowers from the FHLBanks with the interests of all members as investors in the FHLBanks.
- A self-capitalizing structure that uses the private capital of individual members to support their use of advances, intended to enable the FHLBanks to expand and contract their balance sheets in response to changes in membership composition and to fluctuations in the demand for advances.
- A collateral-based lending model designed to protect the members of the cooperative and support portfolio lending.
- The ability to raise low-cost debt in the capital markets based on strong credit ratings, rigorous risk management, joint and several liability for consolidated obligations, and the implicit support of the U.S. government.
- A diverse membership base, including members of all sizes, that supports the ability of the FHLBanks to offer low-cost funding to all members while paying reasonable dividends and that promotes product innovation.

While many policymakers understand and appreciate the valuable role the FHLBank System has played and continues to play in supporting the lending and risk management activities of our nation's community lenders, the significance of each of the attributes listed above may not be apparent to all. Our goal at the Federal Home Loan Bank of San Francisco is to explain and preserve the unique attributes of the FHLBank System, so that we can continue building our strength and fulfilling our housing and economic development mission, through the private capital, enterprise, and commitment of our member financial institutions, for years to come.

## In Closing

As always, we thank our Board of Directors, Affordable Housing Advisory Committee, management,

and staff for their dedication to the achievement of the Bank's mission with and through our members.

Most of all, we thank our members. Many of you have faced your own severe challenges in this extraordinarily difficult environment. We appreciate your understanding of the tough decisions we have had to make in the last few years. We will continue to focus on building our financial strength to support future dividends and capital stock repurchases. We will also continue to make every effort to deliver the financial tools you need to control your funding costs, manage risk, and provide the essential credit needed to achieve full economic recovery in neighborhoods and communities throughout Arizona, California, Nevada, and the other regions you serve.



Timothy R. Chrisman  
Chairman



Scott C. Syphax  
Vice Chairman of the Board



Dean Schultz  
President and  
Chief Executive Officer